



## Highlights

# Budget Proposal

2007

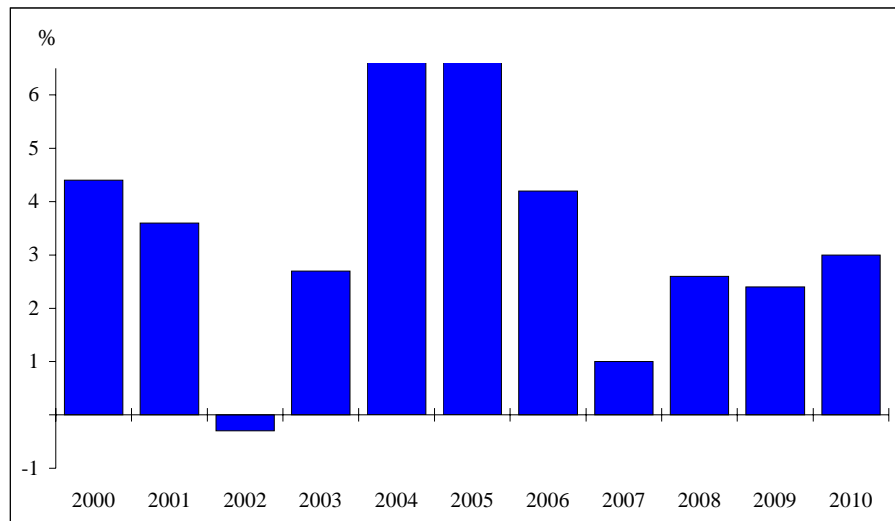
## Budget highlights for 2007

### 1 Economic policy objectives and the fiscal budget

#### A vigorous expansion and rapid growth ...

The economy has been going through a period of vigorous expansion in recent years. This has been the fruit of the Government's economic policy that has placed emphasis upon reducing the involvement of the public sector in economic life through privatisation, upon opening up the economy to competition from abroad and by cutting taxes on companies and households. The large inflow of foreign investment along with innovations in the financial market following the privatisation of the state banks has greatly increased real disposable income of households and economic growth. Employment has increased and unemployment declined. For the years 2003 to 2007 taken together, GDP is estimated to increase by 23 per cent in volume terms, and the real disposable income of households by 22 per cent. These changes brought about a temporary imbalance in the economy that is reflected in a large current account deficit, changes in the exchange rate and a temporary rise in inflation. Experience shows that the economy is very flexible and adaptable. Since economic policy is tight and power-intensive investments are drawing to a close, economic growth is forecast to slow down in 2007 and turnaround in foreign trade will increasingly drive growth in coming years. Medium-term forecasts indicate that the economy will revert towards a better balance at a higher level of income and employment than before.

#### Economic growth



#### ... calls for a continued tight economic policy

Fiscal policy has been tightened in recent years. The Treasury surplus amounted to 5.6 per cent of GDP in 2005 and is estimated to amount to 4.4 per cent of GDP in 2006. In order to ensure a stable economy in the present circumstances, fiscal policy must continue tight in 2007. Fiscal policy has been kept tight by slowing the increase in public consumption and transfer payments at the same time as Treasury investment

has been sharply cut. This policy will be continued next year, when new expenditures due to the departure of the Defence Force will be met with restraint in other current expenditures and the previously intended increase in Treasury investment outlays will be phased in more slowly as the inflow of foreign investment slows down. Investment can be revived once there are clear signs that domestic demand is slowing down and power-intensive investments are largely completed.

### **A responsible fiscal budget**

The 2007 fiscal budget is drafted with a degree of restraint that is in conformity with slower economic growth. It calls for a 15 billion krónur surplus or 1.3 per cent of GDP. This surplus exceeds the medium-term projection as revised for the 2006 fiscal budget by 23 billion krónur. The surplus will create room for the repayment of Treasury debt, thus reducing interest payments.

### **Fiscal restraint is a prerequisite for tax cuts**

Fiscal restraint is not only an important prerequisite for economic stability but also for the implementation of planned tax cuts in line with the Government's policy platform. In light of economic prospects and the timing of power-intensive investments, the closing phase of present tax cuts is scheduled for 2007.

### **Policy for the next four years**

In the 2007 fiscal budget, a revised medium-term projection of the Government is presented for the fourth year in succession. Such a medium-term perspective strengthens the Government's policy and contributes to economic stability. As in previous medium-term projections, the aim is to apply fiscal policy vigorously in order to contain domestic demand at the peak of power-intensive investment and stimulate economic growth once these investments are completed. The main objectives of fiscal policy in 2007-2010 will be the following:

- A tight fiscal policy will be pursued. The annual rate of growth in public consumption of the Treasury will not exceed 2 per cent on average in real terms and the growth in transfer payments will be limited to an average of 2.5 per cent.
- Treasury investment will be cut by 5.5 billion krónur in 2007 from the medium-term projection presented with the 2006 fiscal budget. Investment expenditure will again be increased in 2008 in line with the earlier projection and in accordance with the Act on the disposal of proceeds from the sale of Iceland Telecom.
- A substantial sum will be allocated to tax cuts in 2007 in accordance with the Government's policy platform.

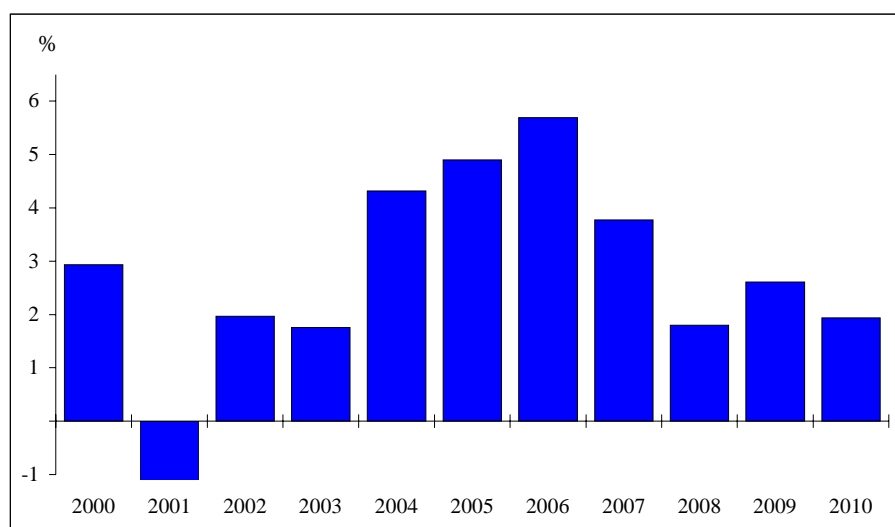
### **The economy has been going through a rapid transformation ...**

The economy has been diversifying rapidly in recent years. The fisheries sector is still the mainstay of exports, but the increase in power-intensive industries, tourism services and high-tech sectors have all strengthened the export base. The Government has encouraged this development through sharply increased spending on education and research and by improving the operating environment of business in general. The ability of the economy to support a better standard of living in a global economic environment has therefore become stronger. Icelandic enterprises have noticeably entered into foreign markets and Iceland's asset formation abroad is growing.

### **... as a result of structural reforms and the increasing globalisation of the economy**

Structural reforms and the increasing globalisation of the economy has transformed the environment of households and businesses in recent years and brought it to the same or higher level than in our neighbouring countries. Substantial tax cuts play an important role in the efforts of the Government. The medium-term objectives of the Government have helped in strengthening the Treasury balance and the counter-cyclical task of fiscal finances. The privatisation of government enterprises in the financial and telecommunications sectors has increased competition and benefited consumers. Structural reforms have also increased the ability of businesses and individuals to participate in the globalisation of the economy which has been increasing in the past decade. These reforms have sharply increased the purchasing power of households and strengthened business operations.

### **The growth in real disposable income**



### **The Central Bank has increased interest rates**

In addition to the prudent fiscal policy, the Central Bank has pursued a tight monetary policy and raised its policy rate in order to restrain domestic demand. These are temporary measures, and at present there are clear signs that domestic demand is moving back towards equilibrium. Following the strengthening of the exchange rate up to the beginning of 2006, the decline in the exchange rate has reduced the growth in imports and will in due course also increase export receipts. The development of the exchange rate in 2006 has led to a tighter access of households to foreign credits. In part, this is due to the fact that foreign policy interest rates, which hitherto have been low, are increasing. International financial markets are also becoming more risk-averse, which has led to a higher risk premium. The effectiveness of the domestic interest rate level is therefore increasing and the debt service burden on foreign debt is rising.

### **Economic growth is higher and unemployment lower than elsewhere**

Most economic measurements reveal Iceland's strong ranking in international comparisons. Economic growth is higher than elsewhere. Unemployment is far below the level common in neighbouring countries. Icelandic businesses have entered foreign markets in a vigorous and determined manner. Since economic growth in Iceland is higher by far than elsewhere and the exchange rate has declined, inflation has increased for the time being but is expected to return back to the Central Bank's target in the latter half of 2007. Looking further ahead, Iceland's position is more favourable than in many other countries. The pension fund system is stronger since it

is fund-based and not based on current revenue paying for current pensions. Treasury finances are also in good order. Treasury debt has declined sharply and there are ample Treasury deposits with the Central Bank.

### Continued economic stability

The main conclusion to be drawn from the fiscal budget and the medium-term objectives for fiscal finances is that the economy will continue to be stable in spite of the wave of power-intensive investments and the rise in domestic demand that are partly attributable to innovations in the financial market. The tight fiscal policy embodied in the budget will also create room for tax cuts in line with the Governments policy statement. A tight fiscal policy as described above is an important prerequisite for a successful implementation of the tax cuts.

## 2 Main elements of fiscal finances

### 2.1 Fiscal finances in 2006

#### Fiscal surplus exceeds the budget by far

Fiscal revenue and expenditure for 2006 has been reassessed in light of developments in the economy and fiscal finances in the course of the year. The following table shows that the 2006 revenue surplus is estimated to amount to 49 billion krónur instead of the budget figure of 19.6 billion. Both revenue and expenditure have increase from the fiscal budget, although revenue has increased more, and the surplus is double what was estimated in the budget, 4.4 per cent of GDP.

#### Treasury finances

Billion krónur, current prices	Accounts 2005	Accounts 2005 <sup>1</sup>	Budget 2006	Estimate 2006	Budget proposal 2007
Revenue.....	421.2	358.8	334.6	375.0	373.4
Expenditure.....	308.4	302.0	315.0	326.0	357.9
<b>Revenue surplus.....</b>	<b>112.8</b>	<b>56.8</b>	<b>19.6</b>	<b>49.0</b>	<b>15.5</b>
Non-financial curr. items..	-77.7	-21.7	-4.1	-2.0	-2.2
<b>Cash from operations.....</b>	<b>35.1</b>	<b>35.1</b>	<b>15.5</b>	<b>47.0</b>	<b>13.3</b>
Financial transactions <sup>3</sup> .....	50.4	16.3	-0.8	-2.6	3.0
<b>Net financial balance.....</b>	<b>85.5</b>	<b>51.4</b>	<b>14.7</b>	<b>44.4</b>	<b>16.3</b>

<sup>1</sup> Excluding the sale of Iceland Telecom.

<sup>2</sup> Including proceeds from asset sales.

#### A sharp increase in growth is reflected in increased revenue

Total Treasury revenue was estimated at 334.6 billion krónur in the 2006 fiscal budget. At present, revenue is estimated to reach 375 billion, 40 billion over budget despite the cut in taxes. The revised 2006 estimate is based on the 2005 accounts, the collection of revenue so far in the current year and the forecast of the Ministry of the main economic aggregates. A high economic growth rate this year and last is leading to increased tax revenue. The yield from the corporate income tax exceeds the estimate of the fiscal budget by far due to far better corporate earnings in 2005 than were forecast. Revenue from the personal income tax also increases considerably due to the rise in wages and the increase in the number of persons in the labour force in

excess of budget estimates. Furthermore, revenue from the capital income tax exceeds the budget estimate by far. About two-thirds of the increase in tax revenue over the fiscal budget is due to direct taxes. The higher rate of growth of private consumption shows up in increased indirect taxes, particularly in the value added tax and excise taxes. Indirect taxes account for one-third of the increase in total revenue above budget.

Total Treasury expenditure is estimated to amount to 326 billion in 2006, 11 billion more than in the fiscal budget. The increase is primarily attributable to higher wages and prices than assumed in the budget, in addition to increased outlays following the agreement between the Government and the Association of Elderly Persons. Wage increases accorded to unskilled caretaker workers in hospitals and nursing homes cost the Treasury close to 3 billion krónur and the agreement with the Association of Elderly Persons close to 2 billion. The departure of the Defence Force led to an expenditure increase of about 1 billion due to increased operating costs at Keflavík Airport and additional helicopters for the Coast Guard. Appropriations to the Municipal Equalisation Fund increase by 1 billion due to a linkage to Treasury revenue and the local government income tax base. Spending on traffic safety will be increased by 1 billion and, finally, the amount set aside for tax claims written off is increased by 3 billion. In light of increased expenditure, investment outlays of 2-3 billion krónur are being postponed until next year. Other changes are minor.

### **Debt declines sharply**

The Treasury surplus is estimated to amount to 49 billion in 2006 and cash from operations to 47 billion. Adjusting for investment transactions, the net financial surplus is expected to amount to 44 billion, 30 billion more than foreseen in the budget. The financial surplus will be used to repay 23 billion of Treasury debt instead of 11 billion in the budget, and 17 billion will be deposited with the Central Bank instead of a withdrawal of 1 billion in the budget. Four billion will be paid to the Government Employees Pension Fund to reduce the future commitments of the Treasury to the Fund. This amount is unchanged from the budget.

## **2.2. Main elements of the 2007 fiscal budget**

The 2007 Treasury surplus expected higher than had been forecast

The 2007 Treasury surplus is projected at 15.5 billion krónur and cash from operations at 13 billion. The net financial balance is thought to exceed 16 billion and that it will be used to continue repaying debt and improve the Treasury's asset position. The revenue surplus of the Treasury exceeds by far the 2006 projections outlined in the Government's medium-term objective. Instead of a 7.1 billion deficit and a commensurate withdrawal of funds from the Central Bank, the 2007 budget calls for a sizeable surplus and a stronger Treasury position. This result is expected to be achieved in spite of unforeseen expenditure due to the departure of the Defence Force and the use of the sales proceeds from the privatisation of Iceland Telecom next year. The turnaround in Treasury finances amounts to 23 billion, in part because of increased revenue and partly because of a tighter expenditure stance such as by postponing earlier investments plans.

### **Revenue declines in nominal terms**

Treasury revenue is expected to decline in nominal terms in 2007 from this year. Total revenue is estimated at 373.4 billion, a decline of 1.7 billion from this year's estimate. The decline amounts to 4.7 per cent in real terms, especially due to less economic

growth and a decline in private consumption. The decline in revenue may also be attributed to the planned cut in the personal income tax rate by 1 per cent and an increase in the standard personal income tax credit. The increase in the tax credit will cost the Treasury 13 billion krónur in revenue. The increasing strength in Treasury finances will thus be partly allocated back to households, and in addition, spending on pensions and welfare will increase.

### Spending on welfare increases sharply

The total expenditure of the Treasury is expected to amount to 357.8 billion in the fiscal budget, an increase of 31.8 billion from the estimated for 2006 or by 5 per cent in real terms. The increase in real terms is slightly lower than anticipated in the Government's medium-term objective of 2006. The increase in expenditure is mostly going into sharply rising welfare expenditure and communications (roads, harbours etc.). Expenditure increases also due to the takeover of tasks from the Defence Force. The helicopter service of the Coast Guard will be strengthened. More funds are being allocated to research and education in accordance with the policy of the Science and Technology Policy Council. Finally, foreign aid is increasing in line with the Government's policy. In order to meet increasing costs in various areas due to the departure of the Defence Force, a number of expenditure cuts have been decided upon for a total of nearly 11 billion krónur.

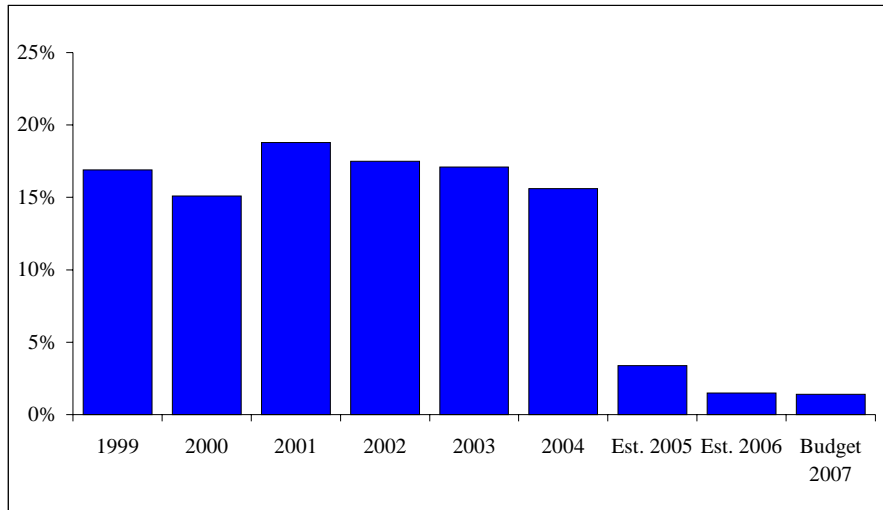
### Revenue surplus excluding irregular items

	Acc. 2003	Acc. 2004	Acc. 2005	Budget 2006	Est. 2006	Budget proposal 2007
<b>Revenue surplus .....</b>	<b>-6.1</b>	<b>0.5</b>	<b>112.8</b>	<b>19.5</b>	<b>49.0</b>	<b>15.5</b>
Irregular expenditure .....	14.4	23.5	13.9	10.8	13.8	10.8
Irregular revenue .....	9.9	1.1	64.1	0.5	0.1	0.3
<b>Rev. surpl., excl. irreg. items ...</b>	<b>-1.6</b>	<b>22.9</b>	<b>62.6</b>	<b>29.8</b>	<b>62.7</b>	<b>26.0</b>

### Strong fiscal restraint

The fiscal surplus is projected at 15.5 billion krónur next year. Adjusted for irregular expenditure and revenue, the surplus is expected to amount to 26 billion krónur. Irregular revenue refers to items such as profits from the sale of assets and asset revaluation, whereas irregular expenditure covers pension fund commitments and the write-off of tax claims. By this measurement, the Treasury surplus is a better reflection of the general operations of the Treasury and the impact of Treasury finances on economic management. The table above shows that the Treasury surplus excluding irregular items amounted to nearly 63 billion krónur both in 2005 and 2006. It is therefore evident that the restraint exercised by fiscal finances has been substantial in both years, since Treasury finances have been getting stronger in recent years. By now, interest income of the Treasury exceeds its interest payments, since the Treasury's deposits with the Central Bank exceed 100 billion krónur. Debt has been reduced and the Treasury's cumulative prepayment of future pension fund commitments amounted to 100 billion in addition to interest by the end of last year. The net debt of the Treasury is estimated to amount to 1.4 per cent of GDP at the end of 2007, having declined from 32 per cent in 1997. The Treasury is therefore well prepared for meeting unexpected circumstances without having to resort to short-term measures.

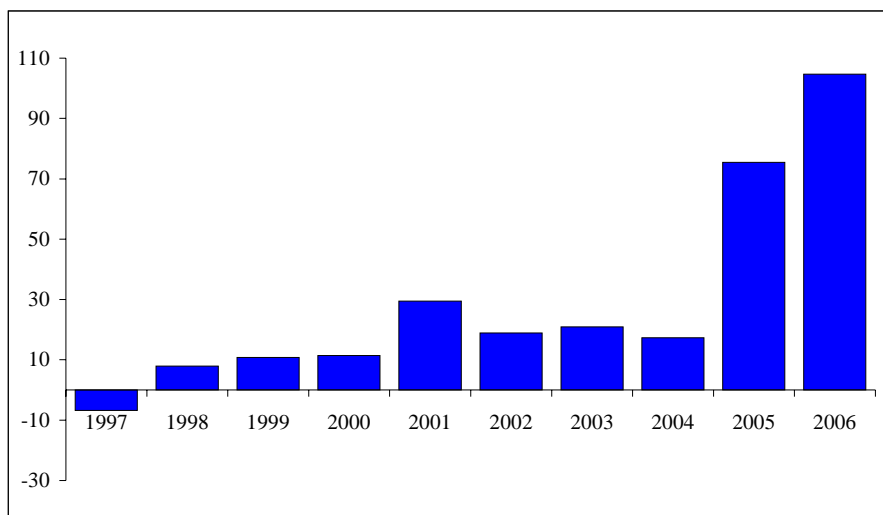
### Net Treasury debt in per cent of GDP



### The gains are being returned to taxpayers

The net wealth tax has been abolished in steps in recent years as well as the personal income surtax. Taxes on business and individuals have been cut and a determined effort has been made to reduce the unfavourable marginal impact of the tax system. This policy, along with the policy of loosening the grip of the state on the economy, has yielded an increased participation in the labour market, innovation and entrepreneurship. The strength of Treasury finances makes it possible to take further steps in this direction without endangering fiscal finances.

### Treasury position with the Central Bank Billion kr.



## 3 Medium-term fiscal objectives

### 3.1 Introduction

The Government has increasingly adopted an economic policy stance that looks several years ahead. This strengthens the credibility of economic policy and contributes to economic stability. The drafting of such policy objectives are laid out in the Government Financial Reporting Act of 1997 where it is stated in Article 28: "A projection of government finances for the next three years following the next fiscal year shall accompany the fiscal budget bill each year. It shall outline the prospects for



government finances with a view towards general economic conditions on one hand and the policy of the government with respect to fiscal finances on the other. The projection shall include an assessment of the fiscal impact on the economy and employment, intentions for the procurement of revenue and the division of expenditure, appropriations for investment and a summary of the government's debt operations and debt service. Once the fiscal budget bill has been passed into law the medium-term projection shall be reviewed and placed before the Althingi if significant changes have taken place in its premises.”

The Government set out its medium-term policy objectives for fiscal finances in the autumn of 2003 for the 2004-2007 period, i.e. for the fiscal year 2004 and the next three years. The fiscal policy objectives were based on the Government's [Policy Statement](#) of May 23rd 2003 as follows:

“Ensuring a balanced and stable economy. This will create conditions for even further growth in national income and higher real wages for the public at large. Economic stability is also a precondition for the improved competitiveness of Icelandic businesses.

Maintaining fiscal balance. Fiscal policy will play a key role in economic policy implementation over the coming years and needs to be flexible towards economic developments. Reforms aimed at cutting costs in central government operations will continue and procedures will be evolved further for more efficient handling and implementation of the Treasury budget. In this respect it is important to take a longer-term view than one year at a time.

Taking advantage of the Treasury's improved scope for securing higher real wages, through systematic tax policy measures.”

The provisions of the Financial Reporting Act regarding the annual presentation of a medium-term projection for the Treasury is therefore not dependent on the remainder of a term of office between elections. The present projection applies to the years 2007-2010 and is based on the main assumptions of the Government regarding the growth in expenditure and tax cuts, including plans for the use of funds from the sale of Iceland Telecom. The projection has as usual been reviewed in line with new decisions and circumstances, taking economic conditions into account.

### **3.2 Fiscal policy objectives**

#### **Investment will be cut**

The Government has agreed to the following objectives for fiscal finances for the years 2007-2010. They are largely unchanged from the previous year:

- Expenditure restraint will be exercised by holding the average annual growth in public consumption to no more than 2 per cent in real terms and that the growth in transfer payments should not be more than 2.5 per cent on average a year.
- Treasury investment will be cut by 5.5 billion in 2007 from earlier plans set out in the 2006 projections. Instead, investment will be increased in 2008 in accordance with the earlier projection and the Act on the disposal of sales proceeds from the privatisation of Iceland Telecom.
- A substantial sum will continue to be allocated for tax cuts in 2007 in accordance with the Government's Policy Statement.

### **3.3 The main assumptions underlying the medium-term projection**

#### **Power-intensive investments are being completed**

The Ministry of Finance has assessed economic prospects for the years 2007-2010 and these prospects are used as a basis for the Government's medium-term policy objectives.

The revenue side of the 2007 fiscal budget incorporates assumptions on substantial tax cuts in 2007. It is assumed that the personal income tax will be cut and that the standard personal income tax credit increased. The objective is to increase participation in the economy and raise the standard of living, having also regard to the fact that power-intensive investments are being completed and the economy is slowing down.

#### **Automatic fiscal stabilisation**

The increase in economic activity in recent years has yielded substantial Treasury surpluses. To a large extent, this is due to automatic fiscal stabilisers that produce surpluses in times of expansion and deficits in a recession. The Treasury thus performs its fiscal management function by withdrawing funds from the economy in an expansion and re-injecting them in a recession. The decline in public investment in recent years has also led to a surplus despite tax cuts. Economic growth is forecast to slow down in 2007, but the Treasury is projected to yield a surplus although revenue will begin to contract and expenditure increase. For the years 2008-2010, a moderate rate of growth is forecast. Assuming that fiscal policy will remain unchanged in emphasis in future years at the same time as investment is increased, and the tax systems will not be amended further, the Treasury is expected to be run at a small deficit that will be financed through the withdrawal of deposits from the Central Bank. The Government's policy is to balance the fiscal budget over the longer term, i.e. that the Treasury will be in balance over the whole of the business cycle by allowing automatic fiscal stabilisation to take its course.

#### **A change in emphasis**

The main assumption on the expenditure side is that spending restraint will continue. For next year, a considerable cost will be incurred from the departure of the Defence Force that was not foreseen in earlier projections. The Treasury has assumed the increased cost of running Keflavik Airport, and the helicopter service of the Coast Guard has been strengthened. It was evident that this cost increase could not be contained within the Government's objective of a 2 per cent annual increase in real public consumption, and expenditure cuts in other areas were therefore resorted to. Treasury public consumption is expected to increase by 2 per cent in real terms from 2006 to 2007, but excluding the cost on account of the departure of the Defence Force, the growth is estimated at 1 per cent. Excluding these expenditures, the growth in current expenditure on education is highest in accordance with the Government's policy of strengthening education and research. Expenditure on homes for the elderly and on foreign aid is also increased. Transfer payments will increase next year in excess of the medium-term objectives due to an agreement with the Association of Elderly Persons. In addition, child benefits will increase and the Treasury will make an extraordinary contribution to pension funds in order to mitigate disability benefits between them in accordance with the Government's statement in connection with the revision of wage agreements.

### **Increased spending on welfare**

Unemployment is expected to increase next year, and the income-linkage of unemployment benefits will come into effect for a full year in 2007. Transfer payments are expected to increase over the next several years in line with the Government's policy to substantially increase foreign aid, and the number of pensioners is also expected to rise in line with the composition of the population. All told, transfer payments are expected to increase by 10 per cent in 2007. From 2008 onwards, the aim is to limit the growth in transfer payments to the medium-term objective of 2.5 per cent growth in real terms. Investment will be cut by 5.5 billion in 2007 from the medium-term projection. Nevertheless, Treasury investment will increase by 5 billion in 2007 and by 10 billion in 2008.

### **Increased funding for education and health**

The expenditure projections for education and health are based on population projections, such as the number of elderly person, the number of students in secondary and higher education etc. The growth in funding for education and health is thus expected to increase by more than 2 per cent or rather by 3-4 per cent a year in real terms. The growth in public administration is on the other hand expected to grow by 1 per cent. Account is also taken of the agreement between the Government and the Association of Elderly Person regarding the increase in pensions and increased services for the elderly. Furthermore, account is taken of the longer-term plan for improving roads and harbours and the Act on the disposal of the sales proceeds from the privatisation of Iceland Telecom, in addition to other issues of emphasis of the Government.

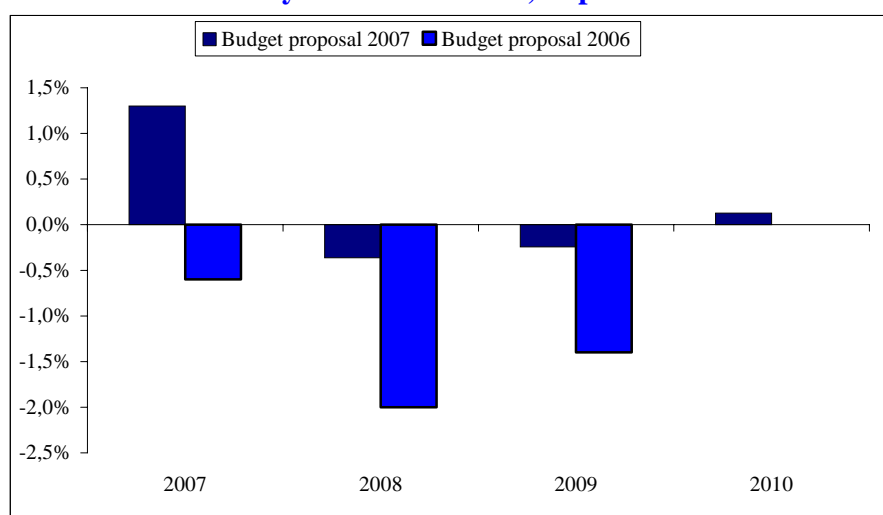
In the medium-term projection, assumptions are also made regarding monetary measures in accordance with the underlying assumptions of the projection itself. It is thus assumed that the Central Bank will keep its policy rate high for some time but begin to reduce it in the first half of 2007.

## **3.4 The main conclusions of the medium-term projection**

### **The purchasing power of disposable income increases**

The main conclusion of the medium-term projection is that the economy will continue stable, although the activity surrounding power-intensive investments will rapidly wind down and the growth in domestic demand will be slower. Economic growth in 2007 will be little but increase again in 2008 to 2010. Large imports of investment goods related to power-intensive investment has inevitably led to a large current account deficit that will be substantially reduced when power-intensive investment winds down and aluminium exports begin to increase. Inflation has increased in the wake of the decline in the exchange rate in 2006 but is forecast to slow down in 2007. Wage increases in connection with the agreement between unions and employers on the revision of central wage agreements as well as planned tax cuts will continue to increase real disposable income, although at a slower pace than previously.

### The Treasury revenue balance, in per cent of GDP



The tight fiscal policy assumed here has created room for a tax cut. Sizeable Treasury surpluses in recent years have also been used to reduce debt and bring down the interest payments of the Treasury. For 2006, the Treasury surplus is estimated to amount to 4.4 per cent of GDP, and for 2007 a surplus equivalent to 1.3 per cent of GDP is projected. This is a considerable change from the previous projection of a 7.1 billion krónur deficit equivalent to 0.6 per GDP. This result will be achieved in spite of considerable additional expenditure following the departure of the Defence Force from Keflavík Airport, since this increase will be met with cuts in other areas. Treasury debt will be reduced by 11.4 billion in 2006 and the Treasury's balance with the Central Bank is expected to improve due to the sizeable Treasury surplus for the year. Projections for 2008 and 2009 show minor deficits for those years, turning to a small surplus in 2010.

#### Income taxes will be cut further in 2007

Some of the Treasury deposits with the Central Bank after the privatisation of Iceland Telecom will be used and national expenditure is expected to actually decline as economic growth slows. The last phase of the cut in the personal income tax will be implemented in 2007.

#### Forecast of main economic aggregates

Volume change in p.c.	2006	2007	2008	2009	2010
Private consumption	4.0	-1.8	0.3	1.9	2.2
Public consumption	2.7	2.1	2.4	2.4	2.4
Investment	8.3	-21.6	-22.4	-1.2	4.7
Total national expenditure	5.2	-6.4	-4.4	1.4	2.7
Exports of goods and services	3.7	10.1	11.6	3.8	3.0
Imports of goods and services	5.2	-9.4	-6.1	1.6	2.2
Gross domestic product	4.2	1.0	2.6	2.4	3.0
Curr. acc. in p.c. of GDP	-18.7	-10.7	-3.8	-2.7	-2.4
Changes in income and prices, p.c.					
Disposable. income per capita	13.4	8.5	4.3	4.9	4.0
Wage increases	9.2	5.5	3.5	3.5	3.5
Real disp. income per capita	5.7	3.8	1.8	2.6	1.9
Consumer price index	7.3	4.5	2.5	2.2	2.1
Exchange rate index, points	122.0	126.0	127.8	128.0	128.0
Unemployment in p.c. of labour force	1.3	2.1	3.1	3.1	2.5

It should be kept in mind that this is a forecast scenario of a possible development four years into the future based on a large number of uncertain assumptions, both as regards domestic and foreign events. The figures published here should therefore be viewed with a caveat and they can at best give an indication of the future development of the economy and Treasury finances. It is especially uncertain what economic effects will arise from the changes in the tax system assumed here. This is particularly true of the cut in the personal income tax that could lead to increased labour market participation and even reduce expenditure on unemployment compensation. Treasury revenue could thereby increase and improve the Treasury balance.

In this medium-term projection, the assumption is made that the proceeds from the privatisation of Iceland Telecom will be allocated in accordance with law, except for next year. The annual interest cost of the Treasury has declined substantially, and in addition the Treasury earns interest on its deposits with the Central Bank, thus strengthening the Treasury balance. The intention is to use a part of the privatisation proceeds over the next several years for projects that already have been passed into law, particularly roads and similar investments. The Treasury will thereby mitigate the slowdown in the economy upon completion of power-intensive investment through increased infrastructure investment and tax cuts. It will be necessary to continue exercising fiscal restraint over the next several years in order to prevent public consumption from growing in excess of general economic growth in the longer run.

### Treasury finances

Billion krónur	Budget proposal	Forecast		
	2007	2008	2009	2010
Total revenue.....	373.3	382.6	398.6	420.3
Of which: Tax revenue.....	343.8	352.8	368.3	389.3
Total expenditure.....	357.9	387.4	402.2	418.8
Current expenditure.....	164.7	173.7	182.9	192.5
Interest payments.....	16.0	14.6	14.4	14.4
Transfer payments.....	154.1	165.1	174.5	183.7
Maintenance.....	5.0	5.7	5.9	6.0
Investment.....	18.1	28.3	24.5	22.2
Revenue balance.....	15.5	-4.8	-3.6	1.5
Financial balance.....	16.3	-5.8	-5.0	-0.3
In per cent of GDP				
Total revenue.....	31.7	30.1	29.8	29.6
Of which: Tax revenue.....	29.2	27.8	27.5	27.4
Total expenditure.....	30.4	30.5	30.0	29.5
Revenue balance.....	1.3	-0.4	-0.3	0.1
Financial balance.....	1.4	-0.5	-0.4	0.0

The following table shows the development of Treasury expenditure by category on the basis of the above assumptions, presently existing laws, forecasts of the number of older persons, the number of students, existing commitments etc.

## Expenditure by economic category

Million krónur, accrual basis	Budget proposal 2007	2008	Forecast 2009	2010
General administration .....	19,553	20,891	21,227	21,572
Police and security .....	15,479	16,857	14,985	15,142
Education .....	36,261	37,331	38,467	39,728
Health .....	92,574	97,649	103,515	106,120
Social services and welfare .....	87,260	92,063	95,089	96,922
Housing, zoning and environm. ....	3,832	3,819	3,901	3,738
Culture and church .....	13,010	13,010	13,036	13,436
Fuel and energy .....	2,224	2,235	2,249	2,264
Agriculture and fisheries .....	16,081	16,076	16,065	16,009
Industry.....	1,516	1,519	1,527	1,535
Transport and communications .....	25,347	31,179	26,637	25,043
Other economic affairs .....	5,384	5,379	5,390	5,430
Other expenditure .....	39,334	38,316	37,949	38,119
Change in wages, prices and interest .....		11,098	22,104	33,708
<b>Total .....</b>	<b>357,855</b>	<b>387,422</b>	<b>402,141</b>	<b>418,766</b>

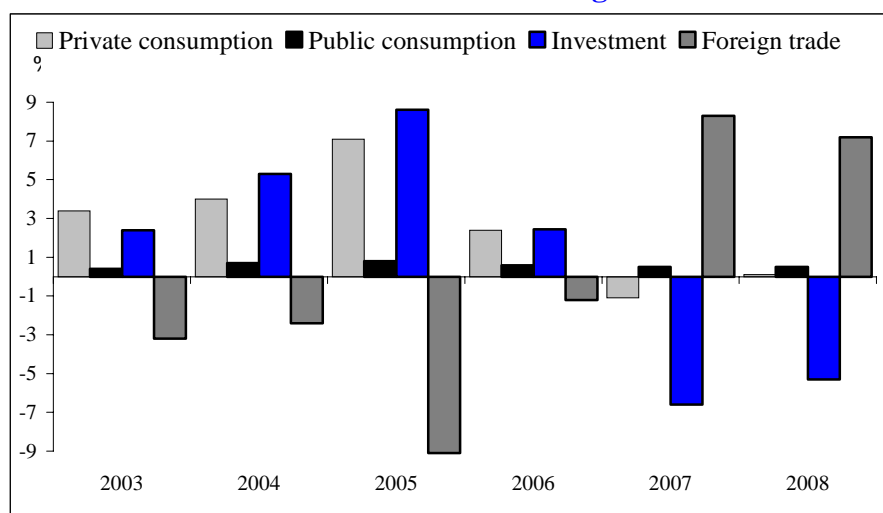
Figures for individual categories are presented at 2006 prices, whereas the cost assessment of wage, price and interest changes are entered as a separate item in order to bring total expenditure for each year to the current wage/price level.

## 4 A summary of the national economic forecast

### Economic growth turned out higher for 2005 than previously thought

The present period of expansion is currently at its peak and has in broad terms developed in accordance with the earlier forecasts of the Ministry. Revised national accounts of Statistics Iceland record a 7.5 per cent real GDP growth in 2005. The earlier account estimates of Statistics Iceland showed a 2 per cent lower growth rate. National income, i.e. GDP plus net transfers of wages and capital income from abroad, rose by 8.6 per cent and national income including the effects of the terms of trade increased by 8.9 per cent in real terms. National expenditure on consumption and investment increased by nearly 16 per cent which explains the growing current account deficit that amounted to more than 16 per cent of GDP last year. National expenditure amounted to 1,138 billion krónur and GDP to 1,012 billion, exceeding the 1,000 billion mark for the first time.

### Contributions to economic growth



### **Real disposable income increases**

The real disposable income of households rose substantially last year or by close to 5 per cent per capita. The private consumption expenditures of households increase on the other hand by 11 per cent per capita in real terms. This indicates that the increase in private consumption was partially financed by borrowing and reduced household saving in 2005. The rapid increase in private consumption was no doubt associated with the sharp rise in asset prices as well as the higher exchange rate and, last but not least, to expectations of rising real disposable income in coming years.

Registered unemployment averaged 2.1 per cent of the labour force last year, and the number of unemployed declined by close to 1,500 persons from 2004. The substantial influx of foreign labour has characterised the domestic labour market. These immigrant workers, who work on power-intensive investment projects and other building projects as well as in various service industries, have no doubt done much to reduce pressures in the economy. Inflation, as measured by the consumer price index, was 3.2 per cent in 2004 and 4.0 per cent in 2005. The rising inflation rate is attributable to the rise in housing prices and the increase in the output gap between 2004 and 2005.

### **Extensive power-intensive investment is drawing to a close**

The construction of the Kárahnjúkar hydropower project commenced in 2003 and will be completed in 2009. The total cost of the project, including transmission lines, is estimated at 110 billion krónur. Construction of the aluminium plant at Reyðarfjörður began in 2004. The expansion of the Norðurál plant at Grundartangi also began in 2004 along with associated power projects. Other business investment increased also sharply in these years after a considerable decline in 2001 and 2002.

The pace of power-intensive investment has changed little since the publication of the Ministry's forecast last June. The total cost of these projects is estimated at 300 billion krónur at 2006-prices. This covers presently known estimates of investment cost, the use of labour and aluminium production capacity resulting from these investments. The foreign cost component of power generation facilities is expected to average 55 per cent and 62 per cent for the construction of aluminium plants. The share of foreign labour in power generation projects and the construction of aluminium plants is estimated at close to 60 per cent over the construction period. These shares can vary between individual years. The total number of man-years is estimated at about 10,000, and close to 2 per cent of the labour force will be engaged in these investment projects at their peak in 2006. In this report, no other power-intensive investments are assumed than those that already have been decided upon.

In the national economic forecast for 2006, real GDP is expected to grow by 4.2 per cent. Growth is expected to slow down next year but revive in 2008. Inflation is also expected to slow down, and the Central Bank's inflation target of 2.5 per cent could be attained in the latter half of 2007. Unemployment is forecast to rise slowly in 2007 and 2008.

## A summary of the forecast

	Bn. kr. 2005	Est. 2005	Forecast		
			2006	2007	2008
Private consumption .....	603.8	12.3	4.0	-1.8	0.3
Public consumption .....	247.1	3.3	2.7	2.1	2.4
Investment .....	288.0	37.6	8.3	-21.6	-22.4
Change in stocks <sup>1</sup> .....	-0.9	0.0	0.1	0	0
Total national expenditure .....	1138.0	15.8	5.2	-6.4	-4.4
Exports of goods and services .....	324.3	7.1	3.7	10.1	11.6
Imports of goods and services .....	450.1	28.9	5.2	-9.4	-6.1
Gross domestic product .....	1012.2	7.5	4.2	1.0	2.6
Gross national income .....	976.9	8.6	5.3	0.8	2.3
Impact of the terms of trade <sup>2</sup> .....	-	0.2	-0.4	-0.2	-0.2
GNI, incl. the terms of trade impact .....	-	8.9	5.0	0.6	2.2
Current account .....	-162.8	-	-	-	-
In p.c. of GDP .....	-	-16.1	-18.7	-10.7	-3.8

<sup>1</sup> In p.c. of the previous year's GDP at constant prices

<sup>2</sup> In p.c. of the previous year's GNI at constant prices

For purposes of the national economic forecast, it is assumed that the exchange rate will remain almost unchanged from the previous forecast. The exchange rate index for 2006 is assumed to average 122 points, which is equivalent to an 11 per cent decline and a 12.3 per cent increase in the price of foreign currency. The index is assumed to rise to 126 in 2007, equivalent to a 3.2 per cent increase in the price of foreign currency. The króna is thus assumed to gradually weaken, partly on account of a reduced foreign currency inflow. The continued issue of so-called krónur bonds by foreigners is subject to considerable uncertainty. These bonds have been bought by foreign investors.

### The causes of the current account deficit

This year's current account deficit is estimated at 209 billion krónur or 18.7 per cent of GDP. A large part of the deficit, some 30 per cent, can be directly attributed to power-intensive investments, but this figure excludes a wide variety of imports by domestic contractors engaged in those investment projects. It should also be kept in mind that the increase in oil prices in the world market have led to about a 10 billion higher import bill in 2006. The current account deficit is expected to decline sharply in 2007 and 2008.

### Inflation is slowing down

Inflation rose in the first half of 2006 but has slowed down in recent months. The average inflation rate between 2005 and 2006 is forecast at 7.3 per cent, declining to 4.5 per cent in 2007 and 2.5 per cent in 2008. As noted above, the inflation target of the Central Bank is expected to be reached in the latter half of next year. The slowdown in inflation is in part based on the recent agreement between unions and employers on the revision of the wage clause in central wage agreements, thus reducing uncertainty in the general labour market. In addition to the above agreement, it is assumed that a tight monetary and fiscal policy will continue to be pursued in order to promote price stability. In this forecast, it is assumed that the Central Bank policy rate will remain at 14 per cent and begin to decline in the first half of 2007. For fiscal policy, the assumption is that public investments will be further postponed this year and next.

National expenditure is forecast to increase by 5.2 per cent in 2006, consisting of a 4 per cent increase in private consumption, close to 10 per cent in business investment



and more than 9 per cent in housing investment. Public consumption is expected to increase by 2.7 per cent and public investment to decline by 19 per cent in 2006.

### **National expenditure forecast to decline in 2007 and 2008**

A turnaround in the economy is expected in 2007. National expenditure is expected to decline by 6.4 per cent with private consumption contracting by 1.8 per cent and investment by 22 per cent. Public consumption is assumed to increase by 2 per cent. The current account deficit is forecast to amount to 10.7 per cent of GDP in 2007. In spite of a considerable decline in national expenditure, real GDP is forecast to increase by about 1 per cent and national income by 0.8 per cent. In this connection, it is important to note that exports are expected to rise sharply and imports decline.

### **A declining current account deficit**

National expenditure is expected to decline still further in 2008, by 4.4 per cent. Real GDP growth is forecast at 2.6 per cent. The decline in national expenditure is primarily attributable to a 28 per cent decline in business investment. Public investment, on the other hand, is going to revive and increase by an estimated 32 per cent. Private consumption is forecast to remain broadly unchanged and public consumption is forecast to increase by 2.4 per cent. Exports will be growing and imports are expected to decline, with the external account thus contributing to the growth of GDP in spite of the decline in national expenditure. The current account deficit is forecast to amount to 3.8 per cent of GDP.